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In the Supreme Court of the United States

OCTOBER TERM, 1976

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

STANDARD LIFE & ACCIDENT INSURANCE COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

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I

THE TREASURY REGULATIONS PRESCRIBING THE TREATMENT OF DEFERRED AND UNCOLLECTED LIFE INSURANCE PREMIUMS PROPERLY REFLECT THE FUNDAMENTAL RELATIONSHIP BETWEEN PREMIUMS AND RESERVES

1. In attempting to support the result reached by the court of appeals that a life insurance company may assume receipt of its deferred and uncollected premiums for purposes of computing its "reserves" but thereafter abandon that assumption when com-

puting its "assets" and "gross amount of premiums," respondent necessarily adopts the position that a company's life insurance reserves are conceptually unrelated to the premiums paid by its policyholders. Thus, respondent contends (Br. 39–50) that it was required by state law to include the net valuation portion of the deferred and uncollected premiums in its reserves and that this state law requirement was a sufficient and independent basis for recognition of such a reserve for federal tax purposes under Section 801(b) of the Code. However, when it comes to taking the deferred and uncollected premiums into account in "assets" and "gross amount of premiums," respondent asserts that it did not receive the premiums and had no legal right to compel their payment.

But as we have pointed out in our opening brief (pp. 29–33), the fundamental relationship between reserves and premiums refutes respondent's bifurcated analysis. Every life insurance text defines a life insurance reserve as made up of the sum of *net valuation premiums paid to date,* plus interest at the assumed rate, minus assumed death claims. See, *e.g.,* MacLean, *Life Insurance* 90–116 (9th ed. 1962).

In view of the fundamental relationship between premiums and reserves, a life insurance company's reserves are not bookkeeping entries created in a vacuum without regard to premiums, as respondent and the court of appeals would have it, but represent liabilities to the policyholders only to the extent that the policyholders pay premiums out of which amounts can be "set aside" to meet future claims. See Section

801(b)(1)(B). Since the deferred and uncollected premiums have not been paid and the company bears no insurance risk with respect to those premiums, the simpler and more logical approach would be to exclude deferred and uncollected premiums altogether from the federal tax computations of the company's "reserves," in accordance with Treasury Regulations, Section 1.801–4(f) (see our opening brief, pp. 54–58).

2. Contrary to respondent's (Br. 39–50) and the *amicus* American Council of Life Insurance's (ACLI) (Br. 10–11) argument, the fact that state law required respondent to compute its reserves on the assumption that it received its deferred and uncollected premiums does not of itself justify recognition of such reserves for federal tax purposes under Section 801(b) without regard to premiums. To be sure, Section 801(b)(2) provides that "life insurance reserves must be required by law" and Section 1.801–5(b) of the Treasury Regulations defines that statutory phrase to mean reserves that are required by state statutes or administrative rules. But there are other elements of the statutory definition of a reserve that demonstrate that a life insurance reserve for federal tax purposes is one that is derived from the premiums paid by the policyholders. Thus, Section 801(b)(1)(A) and (B) provide that a life insurance reserve must also be an "amount" "computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest" that is "set aside to mature or liquidate * * * future unaccrued claims arising from life insurance * * *." If,

as here, the policyholder does not pay the premiums, the company has nothing to "set aside" for the corresponding reserve.

The decisions of this Court uniformly support our submission that a life insurance reserve is tied to the payment of premiums, and that state law characterizations cannot alter this fundamental relationship. In construing predecessor definitional provisions that were essentially equivalent to Section 801(b)(1), the Court has stated that the term "reserve" "does not necessarily include whatever a state official may so designate * * * [but that it] has a technical meaning * * * [as] something *reserved from premiums* to meet policy obligations at maturity." *New York Life Ins. Co.* v. *Edwards,* 271 U.S. 109, 119 (emphasis supplied). Accord: *McCoach* v. *Insurance Company of North Carolina,* 244 U.S. 585, 589; *United States* v. *Boston Insurance Co.,* 269 U.S. 197, 202; *Helvering* v. *Inter-Mountain Life Ins. Co.,* 294 U.S. 686, 689–690. There is accordingly no basis to respondent's and ACLI's contention that state law nomenclature accords independent federal tax recognition to a life insurance reserve without regard to premiums.

Finally, as we have shown in our opening brief (pp. 34–37 and n. 25), the inclusion of the net valuation portion of the deferred and uncollected premiums in reserves derives from the financial reporting assumption of full premium receipt that is used by the life insurance industry in order to avoid the actuarial work involved in computing reserves on a policy-by-policy basis. Thus, the state law which respondent invokes as an independent basis for federal tax recognition of its reserves does not impose an insurance liability upon a company for periods with respect to which premiums have not been paid. To the contrary, the state law simply permits the use of life insurance industry's convention of including the net valuation portion of deferred and uncollected premiums when computing reserves. However, the insurance texts all recognize that the inclusion of such premiums in reserves results in "reserve liabilities * * * [that] are greatly overstated." Wightman, *Life Insurance Statements and Accounts* 545 (1952 ed.); *id.* at 43–44, 155. Accord: MacLean, *Life Insurance* 318–319 (9th ed. 1962); Beardsley, *Life Company Annual Statement Handbook* III–15 (1962); Ernst & Ernst, *GAAP* [Generally Accepted Accounting Principles]—*Stock Life Companies* 449–450 (1974); McGill, *Life Insurance* 867–868 (Rev. ed. 1967). This overstatement of reserves has no actual impact on the company's surplus or solvency because an equal amount is set up as an offsetting asset. MacLean, *supra,* at 318–319.

Both the Commissioner's primary and alternative positions represent different but equally valid methods of dealing with the overstatement of reserves caused by the inclusion of the net valuation portion of deferred and uncollected premiums in reserves. In providing for the inclusion of the gross amount of deferred and uncollected premiums in "assets" and "gross amount of premiums," the primary position set forth in Section 1.805–5(a)(4) and 1.809–4(a)

(1) of the Regulations accepts the industry's convention of overstating the reserves. But since that overstatement rests upon the assumption that all premiums are paid in full, that assumption must be consistently applied so as to include the full amount of deferred and uncollected premiums in "assets" and "gross amount of premiums." By requiring consistent application of the premium receipt assumption, the Commissioner's primary position properly recognizes that life insurance reserves are established only from the payment of premiums.

The Commissioner's alternative position likewise rests upon the fundamental relationship between premiums and reserves. In requiring the exclusion of deferred and uncollected premiums from reserves if they are excluded from "assets" and "gross amount of premiums," Section 1.801–4(f) also avoids the computational imbalance produced by the decision of the court of appeals in this case. It accomplishes this result by recognizing that the financial reporting device of overstating reserves by the net valuation portion of deferred and uncollected premiums is a fiction.[1] It therefore eliminates such premiums altogether from "reserves" as well as "assets" and "gross amount of premiums."

Since the overstated reserves do not represent actual liabilities to policyholders and are not derived from premiums, they do not represent amounts that

[1] This is explained in the trial judge's opinion in *Monumental Life Insurance Co.* v. *United States*, 76–2 U.S.T.C. ¶ 9787 decided November 19, 1976 (Ct. Cl.).

have been "set aside" for the payment of future claims within the meaning of Section 801(b)(1)(B) or the decisions of this Court. Indeed, the exclusion of the net valuation portion of deferred and uncollected premiums from reserves, in accordance with Treasury Regulations, Section 1.801–4(f), finds support in the statement of a leading commentator that these amounts "are not reserves required by law * * * and do not meet the test of funds set aside out of premiums for the benefit of policyholders." Nash, *Federal Taxation of Life Insurance Companies*, § 13.09 (Harman rev. 1976). Thus, the exclusion of deferred and uncollected premiums from reserves, under the Commissioner's alternative position, is neither "strongarm" nor "pernicious," as the *amicus* ACLI argues (Br. 19, 20), but finds solid support in both the insurance texts and the decisions of this Court.[2]

3. Contrary to respondent's (Br. 45–46) and *amicus* ACLI's (Br. 12–13) further argument, neither *Pru-*

[2] While respondent (Br. 48–49) and ACLI (Br. 8, 20–21) argue that Section 1.801–4(f) of the Regulations is invalid, the life insurance industry itself recognized both the underlying concept of the Regulation and the necessary relationship between a company's "reserves" and "assets" almost immediately after the passage of the 1959 Act. More than a year before the Regulations in issue were promulgated, the Conference of Actuaries in Public Practice discussed the possible tax effect of eliminating deferred and uncollected premiums in computing reserves. See Conference of Actuaries in Public Practice, *The Proceedings, 1959–1960*, 36–62. As the following discussion demonstrates, the industry actuaries recognized that a company was required either to include the deferred and uncollected premiums in both its "reserves" and "assets" under the 1959 Act or to eliminate these premiums

dential Inc. Co. v. *Herold,* 247 Fed. 681 (D. N.J.), nor Bulletin H which purports to follow it, are valid precedents with respect to the question in this case. In *Prudential Ins. Co.*, the court concluded that a life insurance company could increase its reserves by the net valuation portion of its deferred and uncollected premiums even though it otherwise excluded such premiums from income under the cash method of accounting then required by the statute.[3]

The *Prudential* decision that a company could include the net valuation portion of such premiums in

from both sets of computations ("Panel Discussion: How to Live With the New Federal Income Tax," *id* at 50);

"Moderator LESLIE. I have another question for you, Ralph: 'What thought has been given to computing reserves on a continuous premium method so that no deferred premium would be required?'

"Mr. NILES. The question here is merely a variation of the overall question as to whether reserves should be maintained as low as possible or as high as possible.

"If a company changes to a continuous premium method so that no deferred premiums are required, there will result a reduction in reserves. And, to determine whether this is good or bad, we must look at the entire picture.

"However, there is an additional complication here. The elimination of deferred premiums will reduce the assets, which, in turn, would increase the current and average earnings rate. So, again, it can only be emphasized that the answer will depend upon the particular situation."

[3] See, *e.g.*, *Mutual Benefit Life Ins. Co.* v. *Herold*, 198 Fed. 199, 214–215 (D. N.J.), affirmed *per curium*, 201 Fed. 918 (C.A. 3), certiorari denied, 231 U.S. 755; *Connecticut General Life Ins. Co.* v. *Eaton*, 218 Fed. 188, 205–206 (D. Conn.), affirmed *per curiam*, 223 Fed. 1022 (C.A. 2).

its reserves turns upon the court's mistaken understanding that the company had an actual reserve liability with respect to these premiums and that it had "effectively withdrawn [assets] from * * * [its] use" to cover this reserve (247 Fed. at 686). But as we have shown, the inclusion of the net valuation portion of deferred and uncollected premiums in reserves results in an overstatement of reserves which is not covered by actual assets (see our opening brief, pp. 35–36). Thus, the one commentator who discusses the *Prudential* decision at length has stated that he does not believe "that the court's conclusion that deferred premiums were properly reserves required by law can be afforded much validity [because] * * * the [case] arose before the development of the definition of reserves required by law reached its full growth." Nash, *supra,* at § 13.06. Since the present statute now requires life insurance companies to use an accrual method of accounting for "all computations" (Section 818(a)) and since it is now well understood that the inclusion of deferred and uncollected premiums in reserves overstates the reserves, the *Prudential* rationale has been discredited.[4]

[4] Between 1921 and 1959, the question whether reserves and premiums could be computed on the basis of inconsistent assumptions became relatively insignificant, because life insurance companies were then taxed solely on "free investment" income, computed under a series of artificial tax formulas (see our opening brief, pp. 22–23).

II

THE STATUTORY PHASE I AND II FORMULAS WILL ACCURATELY MEASURE A LIFE INSURANCE COMPANY'S TAXABLE INCOME ONLY IF PREMIUMS, ASSETS AND RESERVES ARE COMPUTED IN ACCORDANCE WITH A CONSISTENT SET OF ASSUMPTIONS

1. As we have pointed out in greater detail in our opening brief (pp. 39–45, 51–53), the integrity of the federal tax formulas, which rest upon the proportionate relationship between "reserves" and "assets" (Phase I) and upon a net income computation of gross premiums less reserves (Phase II), requires that all of the statutory elements be computed in accordance with a consistent set of assumptions. Respondent disputes the need for consistency and argues (Br. 10, 15–17, 29, 33, 35–36) that there is no statutory requirement that the tax computations be made on the basis of the same assumptions. In support of its contention, it cites (Br. 14–17, 34–35) Sections 806(b), 810(d), and 818(c) as indicating that the premium receipt assumption does not have to be consistently applied across the board.

These provisions have no bearing on the question in this case. They are applicable only to situations in which a life insurance company "strengthens" its reserves by changing the mortality or interest rate assumptions (Sections 806(b), 810(d)) or when it changes its reserve computations from a "preliminary term" to a "net level premium" basis (Section 818

(c)).[5] In each of those special cases, the company simply adjusts the amount of its total assets previously received and then on hand that will be treated as "set aside" (Section 801(b)(1)(B)) for the payment of future death claims.

Here, however, the inclusion of the net valuation portion of deferred and uncollected premiums in reserves overstates the reserves because the premiums on which the addition is based have not been received and could not be "set aside." Thus, nothing in Sections 806(b), 810(d) or 818(c) casts doubt upon our submission that the elements of the tax computation must be computed in accordance with a consistent set of assumptions.[6]

2. Respondent also argues (Br. 6, 10, 11, 15, 31, 33–34) that the 1959 Act does not establish any pro-

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[5] Under a preliminary term system, an insurance company treats the first year of an ordinary life policy as a term insurance policy for one year (hence the expression "preliminary term"). Because the hypothetical one-year preliminary term policy has only a small reserve requirement, this system allows the company to apply almost all of the annual premium for the first year against the company's customarily high first-year expenses. In later years, the company will add larger amounts to its reserves to make up the difference. See, generally, MacLean, *supra*, at 131–140. Section 818(c) allows life insurance companies using a preliminary term system to revalue their reserves for tax purposes on a net level basis. Thus, a company will still be able to claim the same deductions and exclusions with respect to its reserves in the first policy year as if it had not used the preliminary term method.

[6] Respondent further argues (Br. 17–18) that the contradictory assumptions of the court of appeals with respect to assets, gross amount of premiums, and reserves, is consistent with the annual accounting principle "that a deduction is to be allowed for the

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portional relationship and consistency of treatment among reserves, assets, or premium income. There is, however, nothing in the statute that exempts life insurance companies from the general rule applicable to all other taxpayers that all items must be reported in accordance with the same method of accounting. See, *e.g., Helvering* v. *Wilshire Oil Co.,* 308 U.S. 90, 96–99.

The need for consistency is most graphically shown by the net income computation under the Phase II formula. The primary difference between the Phase II formula and the way other taxpayers are taxed is that life insurance companies are allowed deductions for the part of their current income that must be set aside for the payment of future, unaccrued claims. But the only justification for the special deduction allowed by Section 809(d)(2) for increases in reserves is that the company would otherwise be subject to tax on premium income which it must hold for the benefit of its policyholders. Thus, there is no basis upon which respondent could claim a current deduction under Section 809(d)(2) on the ground that it is required to set aside a part of its deferred and uncollected premiums unless those premiums are themselves included in the current year's income. Treasury Regulations, Section 1.809–4(a)(1). By the same token, if respondent wants to defer reporting those premiums as income until the following year, it must also defer its deduction for the part of those premiums set aside for future policy claims. Treasury Regulations, Section 1.801–4(f).

Respondent's contention (Br. 30–33) that reserves and assets are independent variables under the Phase I computation is likewise erroneous. Respondent argues that the Phase I formula does not prescribe a "simple proportional relationship between life insurance reserves and assets" (Br. 31) because the exclusion for the policyholders' share of investment yield is determined in terms of a company's "adjusted reserves [earnings] rate" (Section 805(b)) and "adjusted life insurance reserves" (Section 805(c)).[7] As

year in which it arises and related income is to be taxed in the year when it is received or accrued even if the deduction and the income do not fall in the same tax year." But unlike the case of an ordinary taxpayer, who accrues or pays out otherwise deductible expenses with respect to income received in a subsequent year, a life insurance company's inclusion in reserves of the deferred and uncollected premiums results in an overstatement of reserves that would not normally justify a deduction because it does not represent an actual liability of the company. However, the Commissioner is willing to recognize this overstatement for tax purposes only if the full premium receipt assumption is employed also with respect to "assets" and "gross amount of premiums."

[7] Indeed, respondent even suggests (Br. 30) that our description of the Phase I formula (see our opening brief, pp. 5–6, 39–40) "cannot be derived from the statutory provisions." But as we explained in our opening brief (pp. 5–6, 39–40), Section 805(b) defines a company's earnings rate as the company's investment yield divided by its assets. Apart from the adjustments referred to above in the text, the Phase I formula can therefore be expressed mathematically in terms of the following equations:

$$\text{Earnings Rate} \times \text{Reserves} = \text{Exclusion (Section 805(a))}$$

$$\frac{\text{Investment Yield}}{\text{Assets}} \times \text{Reserves} = \text{Exclusion (Section 805(b))}$$

This equation can be restated mathematically in the following terms:

$$\frac{\text{Reserves}}{\text{Assets}} \times \text{Investment Yield} = \text{Exclusion}$$

Thus, contrary to respondent's argument (Br. 30–33), the statute itself prescribes the proportionate relationship between "reserves" and "assets."

we pointed out in our opening brief (pp. 5–6, nn. 5, 6), both the earnings rate and the amount of reserves used in the Phase I formula are subject to adjustment in the final determination of the amount of the annual exclusion. But while these adjustments make the computation more detailed, they do not alter the essential proportional relationship between assets and reserves that is at the heart of the Phase I formula.

The purpose of these adjustments supports rather than detracts from, our position that reserves and assets should be computed on a consistent basis. As we have noted in our opening brief (pp. 23–24, 39–40), the Phase I formula was established by Congress in order to divide a company's investment income between the company and its policyholders in accordance with the company's actual earnings experience, instead of on the basis of assumed rates of interest used by individual companies or an industry-wide ratio as was the case under prior law. See S. Rep. No. 291, 86th Cong., 1st Sess. 5, 15–16 (1959). Thus, the life insurance industry itself recommended the adjustment pursuant to which an average earnings rate over a period of years (Section 805(b)) would be used in the Phase I formula.[8] As a result, the impact

[8] See, *e.g.*, Hearings on H.R. 4245 (Tax Formula for Life Insurance Companies) before the Senate Committee on Finance, 86th Cong., 1st Sess., pp. 67–68 (statement of Deane C. Davis), 149–150, 165, 175–178 (statement of Richard C. Guest), 252, 259–260 (statement of Henry S. Beers) (1959). A list of the various industry proponents of the Phase I formula was included in a pamphlet prepared by the Staff of the Joint Committee on Internal Revenue Taxation at the time the 1959 Act was considered. See Summary of Recommendations Made in The Hearings on the Taxation of Life Insurance Companies before the Senate Committee on Finance, 86th Cong., 1st Sess. (April 8, 1959).

of disproportionately high or low earnings in any one year is minimized and the formula provides a more realistic method for determining what proportion of a company's total investment income is actually attributable to the company's policyholder reserves and what part represents earnings on the company's own surplus. See S. Rep. No. 291, *supra,* at 5, 15–16; 105 Cong. Rec. 8428–8429 (1959) (remarks of Senator Curtis). See also H.R. Rep. No. 34, 86th Cong., 1st Sess. 10 (1959).

Under the Menge Formula of Section 805(c)(1), a company's life insurance reserves are adjusted to take into account any difference between the company's actual earnings experience and the assumed rate of interest that was used by the company in originally establishing its reserves (see our opening brief, p. 39, n. 29). The formula, which was based on "industry experience," is designed to "restate" the company's reserves as if the company's actual earnings rate had been applied as the assumed rate from the outset. S. Rep. No. 291, *supra,* at 15–16. Thus, the formula provides that a company's reserves are to be reduced 10 percent for each percentage point by which the company's average earnings rate ("adjusted reserves rate") exceeds the assumed rate of interest used by the company in initially setting up its reserves. Conversely, if a company's assumed rate of interest exceeds its adjusted earnings rate, the

company's reserves will be increased by 10 percent for each percentage point by which the company's assumed earnings rate exceeds its actual earnings rate. H.R. Rep. No. 34, *supra,* at 11; S. Rep. No. 291, *supra,* at 15–16. See McGill, *supra,* at 915–916, n. 6. See also Hearings on H.R. 4245 (Tax Formula for Life Insurance Companies) before the Senate Committee on Finance, 86th Cong., 1st Sess., pp. 175–176 (statement of Richard C. Guest) (1959).

Thus, contrary to respondent's argument (Br. 31–32), the Menge Formula does not refute the existence of a proportional relationship between reserves and assets. Instead, it is intended to eliminate any "discretionary actuarial assumptions" in computing reserves and thereby yield a more realistic allocation of earnings between the company and its policyholders. See Hearings on H.R. 4245 (Tax Formula for Life Insurance Companies), *supra,* at 149, 169, 175–178 (statement of Richard C. Guest); S. Rep. No. 291, *supra,* at 5, 15–16. As one industry spokesman who testified in favor of the Menge Formula explained, it was designed to establish a "standardized reserve" that would serve as a more realistic basis for determining the exact "proportion" of a company's total investment income that is attributable to its reserve requirements. Hearings on H.R. 4245 (Tax Formula for Life Insurance Companies, *supra,* at 165, 175–178.[9]

[9] Respondent also suggests (Br. 32, n. 40) that if the company's actual earnings rate exceeds its assumed rate by substantially more than five percentage points, the Menge Formula may begin to overcompensate for the disparity. Indeed, if the actual earnings rate is more than 10 percentage points greater than the assumed rate, the adjustment required by Section 805(c)(1) would eliminate the tax exclusion altogether. Congress, of course, did not contemplate such a disparity between a company's actual earnings rate and the assumed rate at which it credits investment income to its policyholders, and respondent has suggested no reason to doubt the effectiveness of the Menge formula in determining realistic reserve requirements in more normal ranges of experience. In fact, Congress anticipated that competitive pressures in the life insurance industry would prevent any unrealistic disparity between a company's actual and assumed earnings rates, and that the Menge Formula would properly operate within a normal range. See S. Rep. No. 291, *supra,* at 5.

3. Finally, respondent (Br. 26–28) and the *amicus* ACLI (Br. 22–23, n. 30) argue that deferred and uncollected premiums are not includable in a company's "assets" under Section 805(b)(4) because they are not investment-type assets. They urge that the term "assets" in Section 805(b)(4) should be limited to invested assets because the Phase I computation is geared to determining a company's actual earnings rate.

But Section 805(b)(4) makes no distinction between investment and noninvestment assets. It refers to "all assets of the company" with the exception of certain assets (excluding money) used in carrying on the company's insurance business. Indeed, the fact that the statute includes "nonadmitted assets," a term the life insurance industry uses to refer to various assets that cannot be considered in determining a company's solvency, such as debit balances due

from agents,[10] demonstrates that noninvestment assets are within the statutory definition of "asset."[11] As the Fourth Circuit stated in *Jefferson Standard Life Insurance Co.* v. *United States,* 408 F. 2d 842, 858, certiorari denied, 396 U.S. 828, "the Phase I computation is not restricted to invested assets, but encompasses the *total assets* of a life insurance company and the portion thereof devoted to policy reerves" (footnote

[10] See American Institute of Certified Public Accountants, *Audits of Stock Life Insurance Companies* 41–42 (1972); Noback, *Life Insurance Accounting* 94 (1969).

[11] Section 805(b)(4) provides that the only exclusion from its definition of "asset" is "real and personal property (excluding money) used by * * * [a company] in carrying on an insurance trade or business." The exclusion covers office buildings, furniture and fixtures. See Treasury Regulations, Section 1.805–4(a).

Respondent also suggests (Br. 27, 37, n. 46) that deferred and uncollected premiums might be excluded from a company's "assets" on the grounds that these premiums are a "notional asset * * * used in the conduct of the insurance business" (Br. 27). But the argument proves too much. As the court observed in *Jefferson Standard Life Insurance Co.* v. *United States*, *supra*, 408 F. 2d at 858–859, the exclusion in Section 805(b)(4) for "real and personal property (excluding money) used * * * in carrying on an insurance trade or business" must be limited to a company's home office and branch office building, furniture and equipment. All of the assets of a company engaged in the life insurance business are presumably related to the conduct of that business. Thus, if assets such as deferred and uncollected premiums are treated as property used in the trade or business of carrying on an insurance underwriting operation, Section 805(b)(4) would be "rendered meaningless because the exceptions would be construed so broadly as to include literally all assets, so that nothing would be left." 408 F. 2d at 858. See also, *Bankers Union Life Insurance Co.* v. *Commissioner*, 62 T.C. 661, 676.

omitted; emphasis supplied). See also H.R. Rep. No. 34, *supra,* at 10, 12 n. 1.[12]

III

A LIFE INSURANCE COMPANY IS NOT ENTITLED TO A DEDUCTION OR OFFSET FOR THE "LOADING" PORTION OF ITS DEFERRED AND UNCOLLECTED PREMIUMS IN COMPUTING ITS "ASSETS" AND "GROSS AMOUNT OF PREMIUMS"

1. We come now to the position of the *amicus* American Council of Life Insurance. Contrary to the result the court of appeals reached, the *amicus* acknowledges that some part of a life insurance company's deferred and uncollected premiums is includable in "assets" and "gross amount of premiums." However, ACLI contends (Br. 21–32) that a life insurance company is required to include only the net valuation portion of deferred and uncollected premiums in "assets" and "gross amount of premiums." Thus, under the ACLI

[12] Respondent further contends (Br. 28–29, n. 38) that even if the deferred and uncollected premiums are includable in a company's assets under Section 805(b)(4), these premiums should be taken into account at an adjusted basis of zero. But the adjusted basis of an item that is received by a taxpayer as part of its taxable income is determined by the amount that the taxpayer is required to use in reporting the item of income in question. Thus, if a life insurance company is required to include its deferred and uncollected premiums as part of its "gross amount of premiums" under Section 809(c)(1), as we submit, the adjusted basis of these premiums for purposes of Section 805(b)(4) would be equal to the amount taken into income under Phase II.

approach, a company could claim a deduction or offset for the "loading" portion of the deferred and uncollected premiums, *i.e.*, the difference between the gross premium paid by the policyholder and the net valuation premium.[13]

There is, however, no statutory or rational basis for a deduction or offset for loading from either "assets" or "gross amount of premiums" (see our opening brief, pp. 47–48, 54). In support of such a deduction, the *amicus* relies (Br. 23–25) upon the annual statement form approved by the National Association of Insurance Commissioners and used by the insurance departments of most states. Pursuant to the NAIC form, an insurance company offsets the overstatement of its reserves in the amount of the net valuation portion of the deferred and uncollected premiums by creating an asset equal in amount called "Life insurance premiums and annuity considerations deferred and uncollected" (see, *e.g.*, Ex. E, A. 60–61).

But as we have pointed out in greater detail in our opening brief (pp. 34–37, 46–48), the inclusion of the net valuation premium on the assets side of the NAIC form arises from the need to establish a "quasi-asset" to offset the overstatement of the reserves and balance the accounts. Thus, the NAIC method does not clearly reflect income of a life insurance company; it simply provides for corrective adjustments to compensate for the historical practice

[13] Detailed definitions of the terms "loading" and "net valuation premium" are set forth at pp. 8–9 of our opening brief.

of computing reserves on the assumption of full premium receipt. Wightman, *supra,* at 43–44. See also *id.* at 155, 545; MacLean, *supra,* at 318–319. Ernst & Ernst, *supra,* at 449–450; Beardsley, *supra,* at III–15.

What then is the proper impact of the premium receipt assumption upon the "assets" and "gross amount of premiums" computations? For purposes of computing its reserves, respondent used the financial reporting assumption that the annual premiums had been paid in full as of the anniversary dates of each of its policies. It thereupon increased its reserves by the net valuation portion of those premiums—the actuarial amount to be set aside to meet future death claims.

But the assumption underlying the reserve computation was that the policyholders paid their premiums in full and not some lesser amount. Respondent (Br. 3, 24 n. 30, 37 n. 45) and the *amicus* ACLI (Br. 5–6, 11, 30) err in suggesting that the "only assumption * * * is that the net valuation portion of [the] deferred and uncollected premiums has been received by year-end" (Resp. Br. 24, n. 30). The parties stipulated (A. 17) and the Tax Court found (Pet. App. A 3a) that the assumption is that the *gross* annual premium, including the gross amount of all deferred and uncollected installments, is paid in advance on the anniversary date of each policy.[14] Thus, a consistent applica-

[14] Indeed, respondent and ACLI acknowledge elsewhere (Resp. Br. 15, 40; ACLI Br. 6) that the assumption used in computing the reserve is that the policyholder paid the gross annual premium.

tion of the premium receipt assumption requires that the gross amount of the premium be taken into account in "assets" and "gross amount of premiums." Treasury Regulations, Sections 1.805–5(a) and 1.809–4(a). Simply put, policyholders pay gross premiums and not the net valuation portion of their premiums. As the Fifth Circuit stated in *Western National Life Insurance Co. of Texas* v. *Commissioner,* 432 F. 2d 298, 301, "[t]here would be no percentage to be transferred to reserves if the entire deferred and uncollected premiums were not accrued."

2. There is no support for the *amicus* ACLI's contention (Br. 26–29) that Congress intended the NAIC annual statement form to govern the tax computations under the 1959 Act. As we have pointed out in our opening brief (pp. 48–50), Section 818(a) provides that life insurance companies must make all tax computations under an accrual method of accounting. Although the statute also refers to the NAIC annual statement, the pertinent committee reports show that Congress intended that the NAIC method would come into play only when "not inconsistent with the provision of the 1954 Code and an accrual method of accounting." H.R. Rep. No. 34, *supra,* at 42; S. Rep. No. 291, *supra,* at 72–73.

The insurance texts uniformly recognize that the corrective adjustments made on the NAIC annual statements are not consistent either with accrual accounting or with the premium receipt assumption used in the computation of reserves. See Wightman, *supra,* at 43–46; Ernst & Ernst, *supra,* at 449–450.

See also Beardsley, *supra,* at III–15, MacLean, *supra,* at 318–319. Indeed, the life insurance industry's own Joint Committee on Blanks of the American Life Convention and Life Insurance Association of America concluded that "the basic objectives of the annual statement and of the tax return are so different in concept as to preclude revision of the annual statement blank solely to conform to tax accounting concepts." II *Proceedings of the National Association of Insurance Commissioners* 445–446 (1963).[15] Thus, the four courts of appeals that have considered the industry's claim have all properly rejected the argument that the NAIC annual statement employs an accrual method of accounting with respect to de-

[15] Contrary to the *amicus* ACLI's further argument (Br. 27), the fact that state insurance regulation employs the NAIC financial reporting method does not require that it be used for federal tax purposes. As we have pointed out in our opening brief (pp. 36–37), the goal of the various adjustments on the NAIC form is to permit the assumption of full premium payment without distorting the report of the company's solvency on its annual report. However, the federal tax statute requires an accrual method of accounting. To the extent that there are differences, the NAIC form must yield to the tax accrual rules prescribed by Congress. As one text has stated (Denney, Rua & Schoen, *Federal Income Taxation of Insurance Companies* 9.3 (2d ed. 1966)):

"There are several areas where differences exist between the accrual basis used for the annual statement and the general rules of accrual for tax purposes. The insurance business has long been held to be one in which the public interest is of great importance and regulatory laws have been established primarily for the purpose of protecting the policyholder. Consequently, the emphasis of the annual statement has been on the solvency of the company. Such emphasis leads to provisions for contingencies for the purposes of the annual statement which are at variance with tax accrual rules which have been developed throughout the years."

ferred and uncollected premiums. See *Franklin Life Insurance Co.* v. *United States,* 399 F. 2d 757, 760 (C.A. 7), certiorari denied, 393 U.S. 1118; *Jefferson Standard Life Insurance Co.* v. *United States, supra,* 408 F. 2d at 849–850, 855–856; *Western National Life Insurance Co. of Texas* v. *Commissioner, supra,* 432 F. 2d at 301; *Western and Southern Life Insurance Co.* v. *Commissioner,* 460 F. 2d 8, 12–13 (C.A. 6), certiorari denied, 409 U.S. 1063.

3. Moreover, both respondent (Br. 21) and the *amicus* ACLI (Br. 29) argue that the failure to permit a deduction or offset for loading will produce the "anomalous" result that a company will have a larger amount of income in a year if premiums are deferred than it would if they were in fact received. In so arguing, respondent and the *amicus* assume that the loading element is comprised entirely of deductible expenses. Thus, in support of a deduction for loading, respondent and the *amicus* rely upon a line of decisions permitting a deduction only for Phase II purposes for unpaid and unaccrued agents' commissions and state premium taxes that would become payable upon the receipt of the deferred and uncollected premiums. See *Great Commonwealth Life Insurance Co.* v. *United States,* 491 F. 2d 109, 113–116 (C.A. 5); *Federal Life Insurance Co.* v. *United States,* 527 F. 2d 1096 (C.A. 7); *North American Life & Cas. Co.* v. *Commissioner,* 533 F. 2d 1946 (C.A. 8); *United Life & Accident Insurance Co.* v. *United States,* 329 F. Supp. 765 (D. N.H.); *Midland National Life Ins. Co.* v. *Commissioner,* 66 T.C. 550, 563–566,[16] on appeal (C.A. 8).

But these decisions are not authority for the deduction of the undifferentiated loading element of the deferred and uncollected premiums sought by the life insurance industry. They rest upon the narrow rationale that state premium taxes and agents' commissions that are readily attributable to deferred and uncollected premiums are deductible only for purposes of the Phase II income computation under Section 809(d)(12) (now Section 809(d)(11)), which permits a deduction for "all other deductions allowed under this subtitle for purposes of computing taxable income to the extent not allowed as deductions in computing investment yield."

However, contrary to respondent's and the *amicus'* assumption, loading is not a deductible expense but is simply the difference between the gross premium and the net valuation portion designated as actuarially required to be set aside to meet future claims. Thus, loading is not an expense item but an income item analogous to the margin of gross profit built into the selling price for goods and services. As the Seventh Circuit observed in *Federal Life Insurance Co.* v. *United States, supra,* 527 F. 2d at 1098, " 'loading' as a unit * * * [is] a concept not mentioned in the

[16] There is no provision under Phase I for reducing a company's total assets by the amount of any liabilities, whether accrued or unaccrued. See *Republic National Life Insurance Co.* v. *United States,* 77-1 U.S.T.C. ¶ 9133, decided December 9, 1976 (N.D. Tex.).

statute * * * [and] [i]t seems quite proper that not all portions of loading should be allowed as a deduction; loading includes elements of profit which will never be deductible and elements of anticipated expense subject to various contingencies which may or may not ever occur * * *."

Accordingly, there is no statutory or judicial authority in support of the industry's and respondent's alternative claimed deduction (see A. 5) of the loading element from "assets" and "gross amount of premiums." [17]

4. Finally, the anomalous results the ACLI (Br. 29) and the respondent (Br. 38) suggest would occur unless the loading portion of deferred and uncollected premiums is excluded from both the "gross amount of premiums" under Section 809(c)(1) and "assets" under Section 805(b)(4) are, in large part, attributable to the fact that respondent and other life insurance companies compute their reserves on the assumption that deferred and uncollected premiums have been paid, and not to the Commissioner's requirement that deferred and uncollected premiums, if taken into account for the purpose of computing reserves, must be consistently accrued for all purposes under the 1959 Act.

Once the premium receipt assumption and the resulting overstatement of reserves are accepted for tax

[17] Since respondent did not raise the issue of the deductibility of state premium taxes and agents' commissions in the courts below, there is no occasion for this Court to address the additional question presented by the *amicus* Lincoln National Life Insurance Company as to the correctness of the decisions that have thus far uniformly permitted a deduction for those items.

purposes, there will always be differences in tax treatment arising from variations in the amount of annual premiums which a company actually has received and the amount of premiums which it assumes that it has received. The only way to eliminate all such disparities and achieve true tax neutrality between companies that collect all of the premiums taken into account in computing reserves, and those companies that take substantial amounts of deferred and uncollected premiums into account and thereby overstate their reserves, would be to exclude the net valuation portion of deferred and uncollected premiums from the reserves in accordance with Section 1.801–4(f) of the Regulations. Indeed, the courts have properly characterized this approach as both "simpler" and "far more accurate" (*Franklin Life Insurance Co.* v. *United States, supra,* 399 F. 2d at 761; *Great Commonwealth Life Insurance Co.* v. *United States, supra,* 491 F. 2d at 116). Respondent and the life insurance industry can therefore hardly complain of the Treasury's willingness to accept the distortions inherent in the industry's overstatement of reserves on the condition that the gross premium receipt assumption be likewise applied with respect to "assets" and "gross amount of premiums."

"Alternatives," of course, will always be available, here, as elsewhere under the Code. *United States* v. *Correll,* 389 U.S. 299, 306. But it is the function of the Regulations, in the first instance, to choose among such alternatives. As this Court has repeatedly emphasized, "[t]he role of the judiciary * * * begins and ends with assuring that the Commissioner's regula-

tions fall within his authority to implement the congressional mandate in some reasonable manner." *Id.* at 307. Accord: *Bingler* v. *Johnson,* 394 U.S. 741, 749–751; *Commissioner* v. *South Texas Co.,* 333 U.S. 496, 501. The Regulations resolve the deferred and uncollected premium question in a manner that is both consistent with the structure of the 1959 Act and in accord with basic accounting logic. Possible alternative approaches notwithstanding, these Regulations represent a "reasonable and valid exercise of the [Commissioner's] rule-making power" (*Commissioner* v. *Wheeler,* 324 U.S. 542, 546), and should therefore be sustained.

CONCLUSION

For the reasons stated above and in our opening brief, the judgment of the court of appeals should be reversed.

Respectfully submitted.

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